

November 2010

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- Industrial production rose by 5.2% yoy in January-August 2010.
- During the first nine months of 2010, the consolidated budget deficit narrowed by 8% yoy and stood at EUR 5.4 billion.
- In October, consumer prices grew by 7.9% yoy.
- In January-September, the current account deficit widened by 21% yoy to EUR 4.2 billion.
- On November 1st, the IMF mission reached an agreement with Romanian authorities at the staff level on a EUR 0.9 billion disbursement.
- Romania was ranked 56th out of 183 countries in the World Bank's Doing Business report.

Executive Summary

The GDP declined by 1.9% yoy over the first nine months of the year, and 2.5% yoy over the third quarter according to INSSE preliminary press release.

During the first nine months of 2010, the industrial production index rose by 5.2% yoy on the back of stronger output in manufacturing and utilities. Export-oriented industries remained the main driving factors behind growing manufacturing. In fact, robust performance was registered in production of vehicles, chemicals and basic metals. By contrast, domestic-oriented industries like food processing and apparel posted negative growth.

In January-September, the consolidated budget deficit totaling EUR 5.4 billion contracted by 8% yoy. The improvement in public finances was achieved thanks to implementation of summer fiscal austerity measures. Indeed, budget revenues in nominal terms rose by 3.6% yoy and reached EUR 28 billion. At the same time, government spending grew by 1.5% yoy and stood at EUR 33.4 billion.

In October, consumer price inflation exceeded the upper inflation band (4.5% yoy) and increased by 7.9% yoy. This rise in prices was mainly driven by food prices, which were affected by the hike in the VAT rate since July and higher prices of grain on the global markets. Another factor that exerted upward pressure on food prices was the reduction of domestic supply due to summer floods. As a

result, the forecast for annual inflation in 2010 was updated to 8.2% yoy according to the National Bank of Romania.

In January-September, the current account deficit expanded by 21% yoy and settled at EUR 4.2 billion compared to a 50% yoy widening during January-August. The improvement was achieved on the back of faster contraction of trade in goods and some deceleration in current transfers. At the same time, despite a decline in FDI inflows by 39% yoy, they funded half of the current account gap.

On November 1st, a joint mission of the IMF, World Bank and European Commission reviewed the current state of the Balance of Payments assistance program. The IMF mission reached an agreement with authorities at the staff level. As a result, Romania may receive a 7th tranche totaling EUR 0.9 billion at the beginning of 2011 conditioned on adopting 2011 budget law, public sector wage law and pensions law.

Romania moved down by two spots in the "Doing Business" ranking and took 56th place among 183 countries. The drop was led by worse performance in the closing a business and paying taxes categories. At the same time, better performance was registered in dealing with construction permits and trading across borders.

	2005	2006	2007	2008	2009	2010f
GDP growth, % change yoy	4.2	7.9	6.3	7.1	-7.2	-2.0
Industrial production, % change yoy	2.0	7.1	5.4	0.9	-5.5	3.0
Consolidated budget balance, % of GDP	-0.8	-1.7	-2.4	-4.8	-7.2	-7.0
Unemployment, end of period		5.2	4.1	4.4	7.8	8.3
Inflation, end of period	8.72	4.87	6.56	6.30	4.75	8.1
Retail sales, % change yoy	17.5	13.5	17.8	13.0	-8.5	1.8
Gross forex reserves of the NBR, EUR billion, end of period	18.3	22.9	25.3	28.3	30.9	33
Current Account Balance, EUR billion	-6.89	-9.97	-16.68	-16.16	-5.05	-6.3
Total gross external debt, EUR billion	30.9	41.2	58.6	72.4	78.7	83.5
Exchange rate, RON/EUR, annual average	3.62	3.52	3.34	3.68	4.24	4.4

Source: INNSE, NBR, The Bleyzer Foundation

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Economic Growth

The Romanian economy declined by 1.9% yoy over the first nine months of the year, according to INSSE press release. Over the third quarter of the year, GDP contracted by 2.5% yoy, while during the first half of the year, GDP reduced by 1.5% yoy.

In January-September, the growth of industrial production remained virtually the same as in the previous eight months and amounted to 5.2% yoy. Industrial output was primarily shaped by good performance in manufacturing (up by 5.5% yoy) and utilities (up by 9.4% yoy). By contrast, the mining and quarrying sector demonstrated negative growth, notably declining by 7.7% yoy.

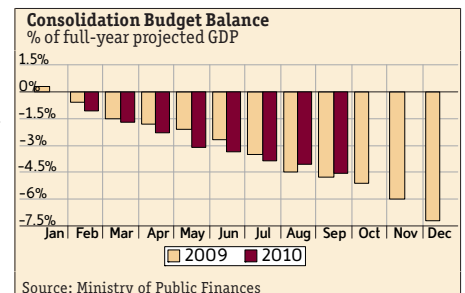
The robust performance of manufacturing was mainly driven by its export-oriented sectors. Indeed, the stronger production of vehicles (up by 33.4% yoy), chemicals (up by 11% yoy) and basic metals (up by 33.2% yoy) was led by higher exports of these commodities during the first nine months of the year. At the same time, those industries oriented to the domestic market showed mixed results. Food processing declined by 6.5% yoy on the back of both weak consumption and low grain harvest caused by summer floods. Moreover, the manufacture of apparel dropped by 2.6% yoy, reflecting weak domestic demand affected by summer fiscal austerity measures. On the other hand, manufacture of textiles and wood products grew by 9% yoy and 12.3% yoy, respectively. At the same time, stronger performance of utilities was supported by growing demand from manufacturing. The future outlook for Romanian industry will be tightly connected with the resumption of growth on global markets, especially in Europe.

Growth of the industrial production index slightly decelerated in September. The index increased by 4.8% yoy compared to 5.3% yoy a month ago. The growth of industrial production was underpinned by good performance in manufacturing (up by 6% yoy) and utilities (up by 1.8% yoy). Meanwhile, the mining and quarrying industry continued to decline for a second consecutive month - down by 8.7% yoy.

Given the above developments, the recovery of Romania's economy will be delayed into next year. The scale and timing of the revival will depend on the rebound of global markets and domestic demand. Expected GDP growth could be registered at 2% yoy in 2011, while the decline in GDP at the end of 2010 might reach 2% yoy.

Fiscal Policy

Summer fiscal consolidation measures continued to correct the consolidated budget deficit. Indeed, during the first eight months of the year, budget revenues in nominal terms grew by 3.6% yoy and stood at EUR 28 billion. It was the highest growth rate since the beginning of the year. Meanwhile, government spending totaling EUR 33.4 billion increased by 1.5% yoy, which is slightly higher than 1.3% yoy growth in the previous month. As a result, the consolidated budget slipped to a deficit in the amount of EUR 5.4 billion (or 4.6% of full year projected GDP), which was 8% less than a year ago. Thus, in September-October, the rising trend of budget deficit was reversed. Given these favorable dynamics, Romania may satisfy the IMF target for annual budget deficit totaling 6.8% of GDP in 2010.



In January-September, higher government revenues were registered on the back of sound proceeds from VAT (up by 7.3% yoy) and excises (up by 7.9% yoy), strong non-tax revenues (up by 20% yoy) and transfers from the European Union (up by 122% yoy). In particular, VAT and excises, which replenished one third of the state revenues, contributed around 70% of total growth. Higher VAT collection was explained by a hike in the VAT rate (up by 5 p.p. to 24%) implemented in July. At the same time, the proceeds from direct taxes declined due to weak economic activity affected by fiscal austerity measures. Indeed, wage and income tax, and corporate profit tax fell by 3.3% yoy and by 2.9% yoy respectively. The decline in another important source of budget revenues - social security and healthcare contributions - dropped by 5.1% yoy, reflecting lower labor income.

On the expenditure side, the increase in budget spending was prompted by social transfers (up by 9.3% yoy), other transfers (up by 8.1% yoy) and interest payments (up by 21% yoy). The higher social payments were explained by a high unemployment rate totaling 7.3%. At the same time, the results of summer fiscal consolidation were observed in the reduction of the state wage bill by 6.4% yoy. Taking into account that public sector salaries make up almost a quarter of government spending (23.4% of overall expenditures), this decline substantially contributed to slower growth of total expenditures. The government also reduced its investment in capital infrastructure, as capital investment fell by 28.6% yoy.

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By September, the stock of medium and long term external debt totaling EUR 71.7 billion had risen by 8.9% since the beginning of the year (ytd). The rise was mainly led by higher public and publicly-guaranteed debt (up by 37% ytd), while private external debt decreased by 4% ytd. The growth of external public debt was driven by three IMF loans (disbursed in February, July and September) and two EU tranches (disbursed in March and September).

Monetary Policy

In October, consumer price inflation continued to outpace the upper inflation band. In particular, CPI grew by 7.9% yoy, which was slightly higher than a month ago (7.8% yoy). This rise was prompted mostly by the increase in prices of foods (up by 5.5% yoy), while prices of non-foods and services posted slower growth than in September - up by 10.6% yoy and 6.1% yoy, respectively. Taking into account the main driver of current price evolution (NBR assessed that impact of hike in the VAT rate on the entire consumption bundle equals 61%), high food prices also reflected adverse shocks that came from international and domestic markets. In particular, the NBR pointed out in its Inflation Report that the significant rise of grain prices on global markets and the reduction of the domestic supply due to floods in June-July contributed to higher food prices. Given these developments, the National Bank revised its inflation outlook for 2010 and 2011. Specifically, the annual inflation rate for year-end 2010 is forecasted at 8.2% yoy (up by 0.4 p.p.), while the projection for next year was updated to 3.4% yoy (up by 0.3 p.p.).

Despite the current rise in consumer prices, this trend should be reversed soon. Indeed, tight budgets affected by fiscal consolidation measures will help to reduce upward pressure on prices. As a result, consumer inflation is likely to return within the inflation band (2.0% - 4.0%) at the end of 2011.

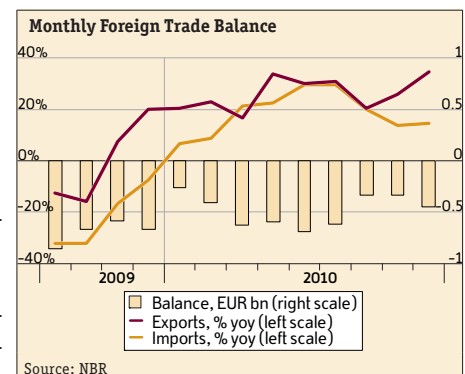
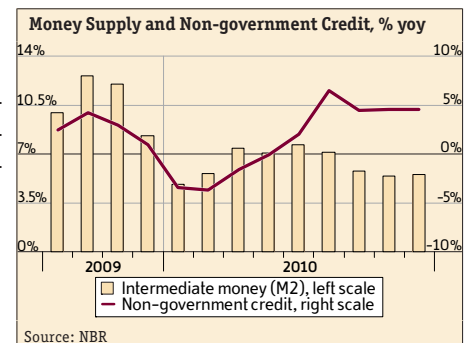
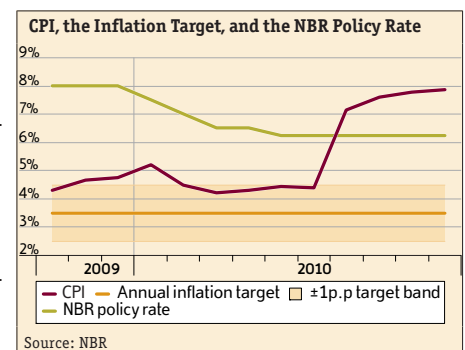
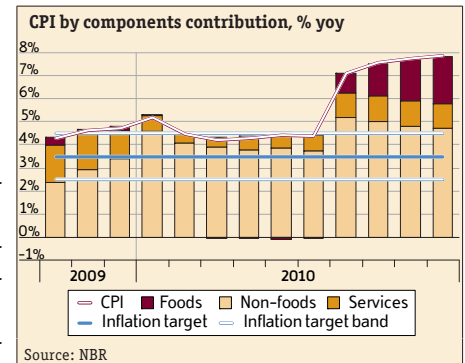
During its last meeting, the Board of the NBR decided to keep its benchmark policy rate unchanged at 6.25%. By this decision, the National Bank tried to anchor inflationary expectations to revive the disinflation trend given the uncertainties linked with global growth and Romania's economic recovery.

In September, the growth rate of money supply (measured as intermediate money M2) slightly accelerated to 5.5% yoy from 5.4% yoy in the previous month. The increase was led by EUR-denominated loans (up by 9% yoy), which grew since October 2009. Moreover, both households and the corporate sector increased their accumulation of loans issued in EUR - by 6.9% yoy and 10.8% yoy, respectively. By contrast, loans denominated in domestic currency continued to decline - down by 3.1% yoy. As a consequence of the robust performance of EUR-issued loans, non-government credit posted 4.5% yoy growth for the fifth month in a row.

International Trade and Capital

During the first nine months of the year, the growth rate of exports in goods outpaced the corresponding rate of imports. In fact, Romania exported 26% more than a year ago, with exports totaling EUR 26.8 billion. At the same time, its imports amounted to EUR 31.1 billion, higher by 19% yoy. As a result, the merchandise trade deficit contracted by 13% yoy and settled at EUR 4.3 billion.

In January-September, the rise in exports was achieved mostly due to stronger overseas shipments of transport equipment and vehicles (up by 27% yoy), industrial raw materials (up by 23% yoy) and chemicals (up by 56% yoy). The exports of transport equipment and vehicles maintained its leading role in the overall expansion of exports, contributing about 40% to total growth. Given the high dependency of foreign trade on the EU (almost $\frac{3}{4}$ of Romania's goods are shipped to the European Union), the future outlook for ex-



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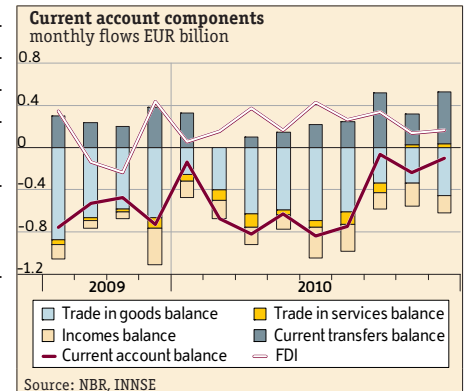
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ports will be tightly connected to the economic recovery in Europe. Meanwhile, Romania's imports were led by higher purchases of fuels (up by 27% yoy), industrial raw materials (up by 16% yoy) and transport equipment and vehicles (up by 25% yoy). More importantly, imports were kept on the deceleration trend since July, when austerity measures were implemented. As a result, the substantial reduction in the monthly growth rate (from 29.4% yoy in June to 14.6% yoy in September) caused narrowing of the merchandise trade gap by 33% yoy during the third quarter.

In September, exports of goods posted the highest growth this year. In fact, exports totaling EUR 3.5 billion accelerated to 34.6% yoy from 26% yoy a month ago. Meanwhile, imports slightly accelerated to 14.6% yoy from 14% yoy in the previous month and stood at EUR 4 billion. Due to sound export performance, the merchandise trade deficit narrowed by almost half and reached EUR 0.5 billion.



During the first nine months of the year, growth of the current account deficit substantially decelerated. In fact, the current account gap widened by 21% yoy to EUR 4.2 billion compared to 50% yoy expansion during January-August. This improvement was due to faster contraction of merchandise trade and some deceleration in current transfers (down by 29% yoy compared to a 39% yoy decline in January-August). At the same time, FDI inflows totaling EUR 2.1 billion covered half of the current account deficit, even after falling by 39% yoy.

In October, Romania's international reserves marginally decreased by 1% mom and settled at EUR 35.5 billion. This reduction was explained by higher currency outflows (EUR 0.5 billion) than inflows (EUR 0.2 billion).

Other Developments Affecting the Investment Climate

On November 1st, a joint mission of the IMF, World Bank and European Commission reviewed the current state of the Balance of Payments assistance program. The head of the IMF mission acknowledged that Romania met all the requirements except the ceiling on general government arrears. But authorities promised to repay arrears for the remainder of the program. Since the agreement at the staff level was achieved, Romania can receive the 7th tranche totaling EUR 0.9, pending Board approval in January. Another key points required by joint mission of the IMF and European Commission are the following. Romanian government has to adopt a budget for 2011, in line with the deficit target of 4.4% of the GDP, adopt the unified public sector wage law and revise the pension law. In addition, the European Commission indicated that the 4th tranche (EUR 1.2 billion) will be disbursed if the government also cooperates with Parliament in specific areas such as protection of consumer rights and keeping stability of the financial system.

Conditions for doing business in Romania slightly worsened according to the recent Doing Business ranking prepared by the World Bank. Romania moved down by two spots to 56th among 183 countries. This drop was mostly caused by worse performance in such categories as closing a business (down by 10 spots to 102) and paying taxes (down by 4 spots to 151). Meanwhile, several categories demonstrated better performance than a year ago. Among them there were dealing with construction permits (up by 9 spots to 84) and trading across borders (up by 1 spot to 47). In particular, the substantial improvement in getting construction permits was explained by enforcement of few regulations acts, which allowed for reducing fees and expediting the process.

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